Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:TL-N-1871-01
TKerrigan

date: AUG 9 - 2001

to: Territory Manager (Retail, Food & Pharmaceuticals)
Attention: Group 1518-LMSB

from: Associate Area Counsel
CC:LM:FS:BRK

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subject: [redacted]

Taxable years: [redacted]
U.I.L. Nos. 1441.03-02, 0162.07-02, 1366.00-00, 6324.02-00

Reference is made to our memorandum dated June 22, 2001, in response to your request for advice concerning the current examination of the above-referenced taxpayer. We stated in the memorandum that it was being referred to the National Office for review, that the review might result in modifications to the advice rendered therein, and that we would inform you of the results of the review.

The memorandum was reviewed by subject matter specialists in the National Office. We were notified that they concur with the advice rendered therein. The National Office also believes that a third-party bank summons may provide the requisite information to establish a relationship between the taxpayer and [redacted] Accordingly, we suggest that the revenue agent prepare the appropriate summons to secure the account signature card, corporate charter, corporate resolution and all supporting documents relating the account.

If you have any questions or require additional information, please call Thomas Kerrigan at (516) 688-1742.

ROLAND BARRAL
Area Counsel

By: Jody Tancer
JODY TANCER
Associate Area Counsel

Office of Chief Counsel
Internal Revenue Service

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This memorandum is in response to a request for advice, dated June 4, 2001, from Richard Saul of your staff concerning the current examination of the above-referenced taxpayer. This memorandum should not be cited as precedent.

ISSUES

1. Whether, under the facts presented, the Service should consider issuing third party summonses to determine if a foreign lender is related to the taxpayer?

2. Whether, under the facts presented, consulting fees paid to a former shareholder are deductible under I.R.C. § 162?

3. Whether, under the facts presented, the Service should respect purported loans from shareholders for Federal income tax purposes?

4. Whether, under the facts presented, the Service should consider invoking the gift tax transferee liability provisions with respect to the current shareholders' acquisition of their stock ownership interests from their parents?

FACTS

The relevant facts, as we understand them, are as follows: [redacted] is an importer, distributor and manufacturer of [redacted]. The company was

incorporated in [redacted] and elected S corporation status on [redacted]. [redacted] is owned by [redacted] who has a [redacted]% ownership interest and [redacted] who has a [redacted]% ownership interest. The company was originally owned by the [redacted], the parents of the current shareholders. The date of acquisition and the details of that transaction are not known. The revenue agent believes that the current shareholders probably acquired their respective interests in the corporation approximately [redacted] years ago.

On [redacted], [redacted] borrowed $[redacted] from [redacted], a Panamanian Corporation. The promissory note indicates that the interest rate on the loan is [redacted]%. The taxpayer claimed an annual interest expense deduction in the amount of $[redacted] relating to this loan in the tax years at issue. [redacted] provided [redacted] with a substitute Form W-8 indicating that it is a foreign entity and that the interest income received qualifies as portfolio income not subject to 30% withholding at the source under I.R.C. § 1441. Accordingly, the taxpayer did not withhold any amount when making its monthly interest payments to [redacted] The portfolio interest exemption, however, does not apply to interest payments made to a foreign lender who is related to the borrower. The taxpayer's representative stated that there is no relationship between the parties despite the similarity in their corporate names. The taxpayer offered a letter, dated [redacted], from an attorney in [redacted] who purportedly represents [redacted] The attorney states that "as of today all shareholders of [redacted] are [redacted] citizens and are not in any way related to [redacted] or [redacted]." The taxpayer also provided a second letter to the revenue agent. This letter, which is addressed to the taxpayer's accounting firm and is dated [redacted], makes a similar representation that the parties to the transaction are unrelated.

The revenue agent discussed the issue with the National Office (International), which recommended obtaining additional information regarding [redacted] through its Revenue Service Representatives ("RSR") stationed in Mexico and Italy. The RSR in Mexico obtained limited information from a Panamanian public records search. The RSR determined that [redacted] was incorporated in [redacted]. The registering documents listed the following corporate directors/officers: [redacted]. The corporate record report indicated that these listed directors/officers were all [redacted] citizens. The report also stated that the company issued [redacted] shares of [redacted] stock but contained no stock ownership information. The revenue agent requested assistance from the RSR located in Italy in order to obtain additional information about the corporate

directors/officers. The RSR provided a current address and phone number for [redacted] in [redacted] but could find no listing for [redacted]. The RSR determined that [redacted] had died in [redacted] and was the brother of [redacted]. The revenue agent would like our guidance in further developing this issue.

During the tax years at issue, [redacted] received consulting fees of $[redacted] per annum from the taxpayer. The taxpayer's representative stated that [redacted] acted as a buying agent for the taxpayer. The taxpayer has provided a brief description the duties performed by her in that capacity. In addition, the taxpayer submitted a copy of an agreement with [redacted] Effective [redacted] this [redacted] became the exclusive buying agent for [redacted] in Europe and the [redacted] and purportedly assumed most of the duties that were previously performed by [redacted]. The annual compensation paid to [redacted] was $[redacted]. As of this writing, the revenue agent has not secured the business records to substantiate the payments made to [redacted]. The revenue agent believes that the consulting fees paid require further examination because the transaction involves related parties. In addition, the revenue agent believes that [redacted]' treatment of these payments for foreign tax purposes may be relevant to this inquiry. The revenue agent asks whether it would be appropriate in this instance to make a collateral request with the government of [redacted] to obtain this tax information.

The taxpayer's [redacted] Form 1120S, U.S. Income Tax Return for an S Corporation, Schedule L reflects loans made to the corporation by each shareholder. Schedule L also reflects $[redacted] of capital stock and $[redacted] of paid-in or capital surplus. The loan documents indicate that in [redacted], [redacted] lent the company $[redacted] and [redacted] lent the company $[redacted]. The taxpayer repaid both loans in [redacted]. The revenue agent questions whether the shareholders had sufficient funds available in [redacted] to make such loans. In addition, the revenue agent opines that the "loan repayments" may be actually disguised corporate distributions. The revenue agent requests our views about raising this as a potential issue in the current examination.

LEGAL ANALYSIS

1. Loan from [redacted]

Foreign corporations, which receive interest income from U.S. payors (that is not effectively connected with conduct of a trade or business within the United States) are liable for a tax

of 30% of the interest received. I.R.C. § 881(a). U.S. taxpayers who pay interest to foreign corporations generally are required to withhold the 30% tax from interest payments made to those corporations. I.R.C. § 1441; I.R.C. § 1442. U.S. taxpayers who are required to withhold the 30% tax and fail to do become personally liable for the withholding tax. I.R.C. § 1461. U.S. source interest received by a foreign corporation is not subject to the 30% tax if the interest paid is "portfolio interest". I.R.C. § 871(h); I.R.C. § 881(c); I.R.C. § 1441(c)(9). This "portfolio interest" exemption, however, does not apply to interest payments made to a foreign lender who owns directly or indirectly 10% or more of the voting power of the stock of the borrower. I.R.C. § 871(h)(3). The attribution rules of I.R.C. § 318(a), with certain modifications, are used to determine stock ownership for purposes of determining whether the recipient of interest is a 10% shareholder of the payor corporation. I.R.C. § 871(h)(3); I.R.C. § 881(c)(3)(B).

In the present case, the taxpayer has represented to the revenue agent that there is no common ownership between the parties to the loan. Letters from an attorney, who purportedly represents [redacted], appear to confirm the taxpayer's representation. We do note, however, that the attorney's first letter addresses the ownership relationship as of the date of the letter rather than the ownership relationship at the time then loan was made. Therefore, you may want to obtain a more definitive response from the attorney of [redacted] This would require the assistance of the appropriate Revenue Service Representative to make a third party contact on your behalf. The relevant information request would be the names and addresses of all individuals that had ownership interests in [redacted] when the loan was made. In the alternative, affidavits from the two shareholders of [redacted] stating that the parties are unrelated may be sufficient to allay the revenue agent's concerns. The revenue agent advised our office that he has identified a U.S. bank account for [redacted] and is considering issuing a third party summons to the bank. We believe this proposed summons is unlikely to yield the stock ownership information sought. Therefore, a bank summons would appear to be the least productive of the three potential sources of information.

2. Consulting Fees Paid To [redacted]

I.R.C. § 162(a)(1) provides a deduction for all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business, including a reasonable allowance for compensation for personal services. The test of deductibility in the case of compensation payments is whether the the amounts are reasonable and for services actually rendered. Treas. Reg. § 1.162-7. This is a question to be resolved on the

basis of an examination of all the facts and circumstances of the particular case. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115, 118 (6th Cir. 1949). Payments to relatives require closer scrutiny since generally they are not arm's length transactions. The criteria to be used in making a determination as to the deductibility of payments between related parties includes (1) whether actual services have been rendered, (2) whether the amount paid is reasonable, and (3) whether actual payment has been made. See Rev. Rul. 73-393, 1973-2 C.B. 33 [Service held that wages paid by a father to child for services rendered were deductible under I.R.C. § 162.]

In this case, there appears to be some evidence that [redacted] may have provided services to the taxpayer. The taxpayer's representative alleges that she functioned as a buying agent in Europe. [redacted] had worked for the taxpayer for many years prior to her return to [redacted]. Therefore, she arguably possessed the requisite knowledge and overseas contacts to function as a purchasing agent. Perhaps the most persuasive evidence offered by the taxpayer is the documentation relating to the subsequent hiring of an exclusive purchasing agent. If the taxpayer's representation that the new agent is now performing the duties that [redacted] previously had performed is accurate, the compensation received would appear reasonable for the services rendered. Here, the taxpayer has identified a compensation payment made to an unrelated third party for similar services that is consistent with the amount paid to a relative.

We do not believe a collateral request with the government of [redacted] to obtain [redacted] foreign tax return is warranted. While this information may establish that the payments were treated in a consistent manner by both parties to the transactions, it is not dispositive of the reasonable compensation issue. Because of the inherently factual nature of any reasonable compensation determination, we believe that this issue requires further factual development. The revenue agent should verify that [redacted] rendered valuable services on a regular basis to the taxpayer. The taxpayer should have the records necessary to document the actual work performed by her. In addition, the taxpayer needs to substantiate that the amounts claimed as a deduction were actually paid.

3. Purported Loans From Shareholders

With respect to the shareholders' loans made to the taxpayer in [redacted], we note that the transactions were properly reflected on the corporate tax return. The issues (1) whether these were valid loans and (2) whether the shareholders had sufficient funds available to make the purported loans were not raised in the prior examination cycle. The taxpayer has provided copies of the loan agreements to substantiate the existence of the loans. In

addition to this documentation, we recommend securing copies of any wire transfers or cancelled checks. This purpose of this additional documentation is to ensure that there was a true debtor-creditor relationship and to determine the source of funds advanced by the shareholders. If the taxpayer is unable to substantiate the loans at issue, the revenue agent may consider treating the repayments as taxable distributions that are passed through to the individual shareholders. I.R.C. § 1366(a). The revenue agent will need to factually develop this issue and should requested further guidance from our office before proposing any adjustment.

4. Gift Tax Transferee Liability

The final issue raised by the revenue agent relates to the current shareholders' acquisition of the corporation from their parents. The revenue agent does not have any information relating to the stock transfer but believes that the stock may have been transferred to the current shareholders for no consideration. The revenue agent has not determined if a gift tax return was filed and asks whether the gift tax transferee liability provisions would be applicable to this factual scenario.

I.R.C. § 2501 imposes a tax on the transfer of property by gift. Treas. Reg. § 25.2511-1(c) defines the term "gift" to include "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed." A transfer of property is not considered a taxable gift, however, if the transfer is made in the ordinary course of business. Treas. Reg. § 25.2512-8. A transfer between family members may qualify for the "ordinary course of business" exception if there is sufficient evidence that the transaction is a genuine business arrangement, i.e. the transfer was bona fide, at arm's length, and free of donative intent. Bergeron v. Commissioner, T.C. Memo. 1986-587. These types of intra family transfers require closer scrutiny than an unrelated party transaction that turns out to be a "bad bargain" for the transferor.

The donor is liable for the filing a gift tax return and for paying the gift tax. I.R.C. § 6019; I.R.C. § 2502(c). The timely filing of a gift tax return starts the running of the statute of limitations for assessment of additional gift taxes. I.R.C. § 6501 provides that the amount of any tax imposed generally must be assessed within three years after a return is filed. I.R.C. § 6501(e)(2) extends the limitations period to six years if the gift tax return omits items of value in excess of 25% of the total amount of gifts stated on the return for that period. There is no statute of limitations on assessment if a gift return is not filed. I.R.C. § 6501(c)(3).

I.R.C. § 6324 provides for a special gift tax lien. This lien comes into existence upon the making of a gift by a donor. The gift tax lien attaches only to the property that is the subject of the gift and is valid for ten years from the date of the gift. If the gift tax is not paid when due, the donee is personally liable for the payment of the tax to the extent of the value of the gift to the donee. I.R.C. § 6324(b). The statute of limitations for assessment against a donee is one year after the expiration of the limitations period against the transferor. I.R.C. § 6901(c)(1). In general, the Service will only invoke transferee liability in situations where the statute of limitations has expired with respect to the donor. See IRM Handbook No. 4.3.8, Estate and Gift Tax Handbook, Section 4.8, Transferee Liability Cases.

In this examination, no facts have been developed relating to the stock transfer. Therefore, it would be premature at this time to consider invoking gift tax transferee liability. At a minimum, the current shareholders should be able to provide information relevant to their acquisition of [redacted] The revenue agent will need ascertain following information before an evaluation of potential transferee liability can be made: (1) the date of the stock transfer, (2) the fair market value of the property transfer, (3) the amount of any consideration, if any, paid for the property. In addition, the revenue agent should conduct a search the Service's records to determine whether a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return has been filed.

CONCLUSION

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

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Area Counsel

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